



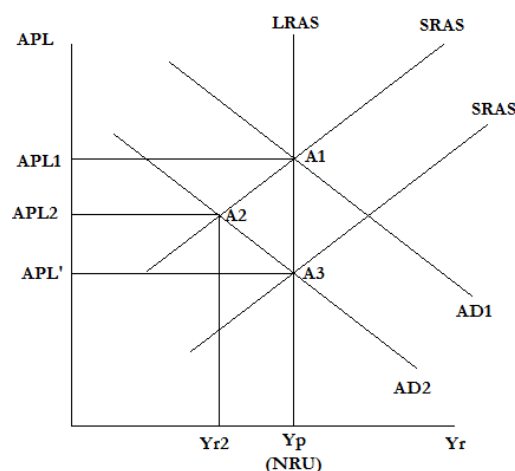
11 o'clock files

Simply Gaps & Adjustments

The Monetarist Take

Case of a deflationary gap

- Assume an economy in equilibrium at its potential level of output Y_p where unemployment is at its NRU
- If AD decreases to AD2 (because of, say, a decrease in consumer and business confidence) then the average price level decreases (APL2)
- Since in the short run money wages are assumed fixed, the real wage increases, inducing firms to decrease output (remember that $w_r = \frac{w_m}{APL}$)
- Real output falls to Y_{r2} and unemployment rises above the natural rate (NRU)
- **A deflationary gap arises equal to $Y_{r2}Y_p$**
- The economy has moved along its SRAS from point A1 to point A2.

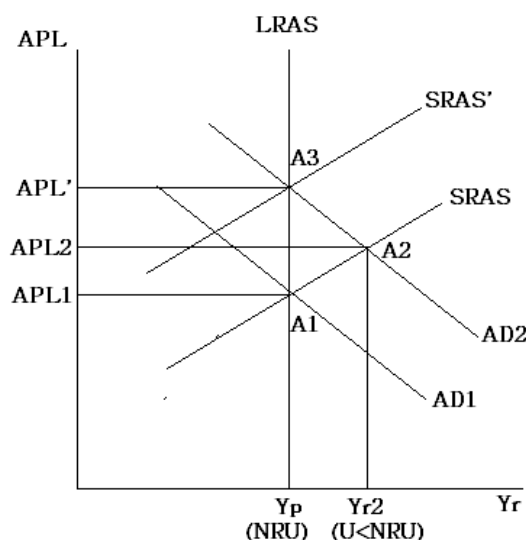


but...

- In the long run, money wages are assumed *flexible* and that they *fully adjust*
- Money wages thus decrease, increasing the SRAS to SRAS' (remember that money wages is a shift factor for SRAS)
- Since the adjustment of money wages is assumed full, the (equilibrium) real wage returns ('**is restored**') to its original level
- Since the real wage is unchanged, unemployment must return to its original, natural rate (NRU) and consequently real output back to its potential level Y_p
- The economy has moved *on its own* (market forces) to point A3
- There is thus no need for Government intervention
- According to the Monetarists, the economy will bounce back solely through market adjustments, namely the decrease in money wages
- Unfortunately, the 'long run' may take too long to come for the unemployed...

Case of an inflationary gap:

- Assume an economy in equilibrium at its potential level of output Y_p where unemployment is at its NRU
- If AD increases to AD2 (because of, say, an increase in G) then the average price level increases (APL2)
- Since in the short run money wages are assumed fixed, the real wage decreases, inducing firms to increase output (remember that $w_r = \frac{w_m}{APL}$)
- Real output increases to Y_{r2} and unemployment falls below the NRU
- **An inflationary gap arises equal to $Y_p Y_{r2}$**
- The economy has moved along its SRAS from point A1 to point A2.



but...

- In the long run, money wages are assumed *flexible* and that they *fully adjust*
- Money wages thus increase, decreasing the SRAS to SRAS' (remember that money wages is a shift factor for SRAS)
- Since the adjustment of money wages is assumed full, the (equilibrium) real wage returns ('**is restored**') to its original level
- Since the real wage is unchanged, unemployment must return to its original, natural rate (NRU) and consequently real output back to its potential level Y_p

- The economy has moved *on its own* (market forces) to point A3
- There is thus no need for Government intervention
- According to the Monetarists, an inflationary gap will close solely through market adjustments, namely the increase in money wages